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IN THE

Supreme Court of the United States

OCTOBER TERM, 1929.

No. 314.

NILES BEMENT POND COMPANY, *Petitioner,*

vs.

THE UNITED STATES, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

(The Jurisdiction Included.)

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Washington, D. C.,
August 28, 1929.

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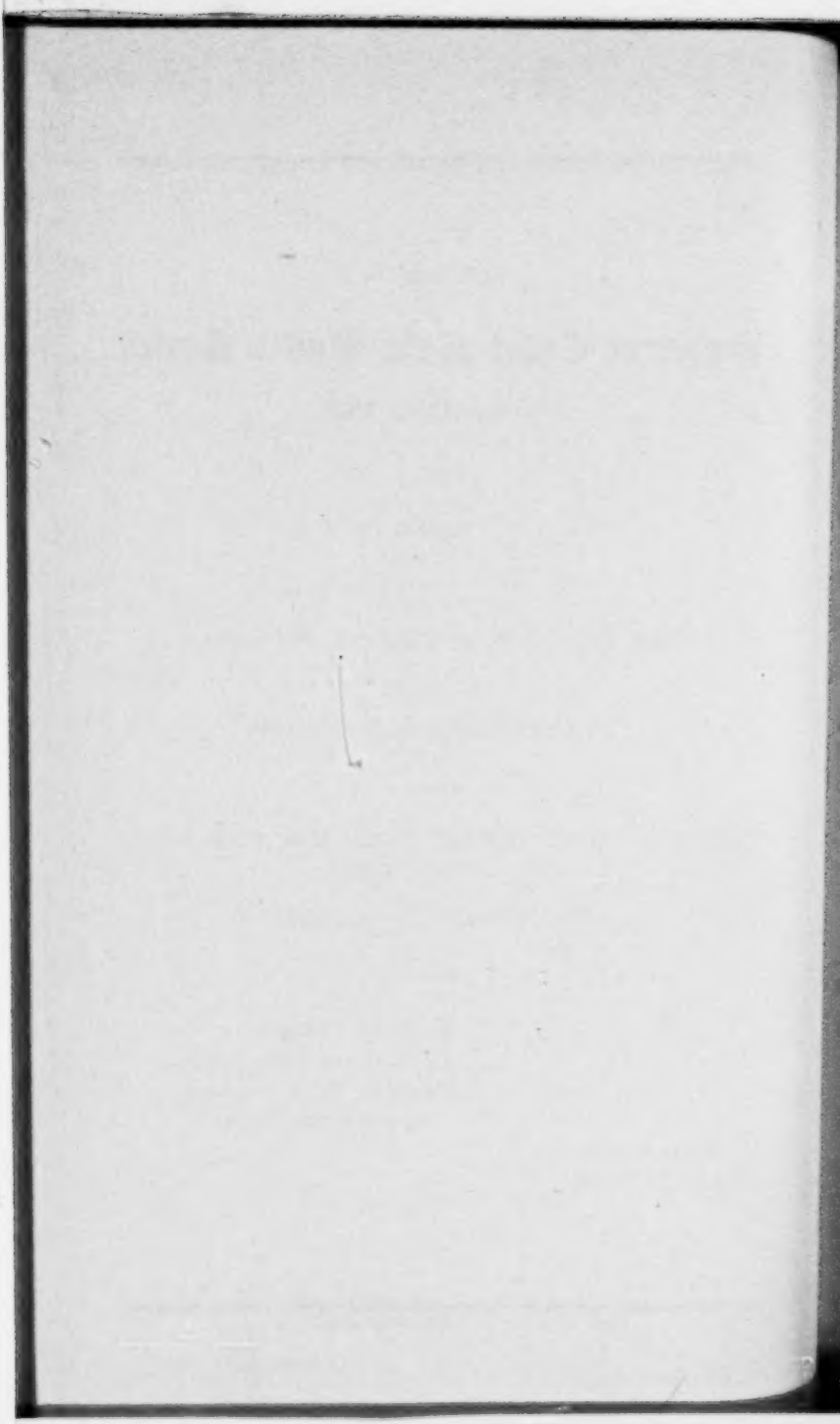

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I.

THE OPINION OF THE COURT BELOW.

The opinion in the Court of Claims is not yet reported. The opinion was rendered by the Court of Claims May 13, 1929 (R. 27).

II.

JURISDICTION.

1. The statutory provision believed to sustain jurisdiction is Section 3(b) of the Act of February 13, 1925; Chap. 229, 43 Stat. L. 939; U. S. C. Title 28, Sec. 288 (b).

2. The date of the judgment sought to be reviewed is May 13, 1929 (R. 40). The petition for certiorari was filed August 9, 1929 (R. 41).

3. This was a case in the Court of Claims instituted by petition to recover federal income and profits taxes alleged to have been erroneously collected (R. 1). General traverse was filed (R. 26), the case was heard upon the evidence and the Court made certain findings of fact (R. 27), rendered an opinion (R. 37) and entered judgment against the petitioner dismissing the petition (R. 40).

4. Cases believed to sustain the jurisdiction are:

Southern Pacific Co. v. United States, 270 U. S. 103;
Culver v. United States, 269 U. S. 550, 271 U. S. 315;
Kornhauser v. United States, 273 U. S. 692, 276 U. S. 145.

III.

STATEMENT OF THE CASE.

This suit was instituted in the Court of Claims to recover corporate income and profits taxes for 1917 and 1918 alleged to have been erroneously and illegally collected by respondent from petitioner. The question here presented is:

Whether petitioner was entitled in 1918 to a credit under Section 238 (a) of the Revenue Act of 1918 (Chap. 18, 40 Stat. L. 1057, 1080) for certain British income taxes and excess profits duties paid during 1918, where the first information received by petitioner as to the amount of such taxes so payable was received in 1918 and the taxes were first entered upon petitioner's books during 1918 as an expense for that year in accordance with the method of accounting regularly employed by petitioner in keeping its books.

The findings of fact upon this question (Nos. V to XI, inclusive), show (R. 28-30):

During the year 1918 petitioner paid to the Government of Great Britain an income tax for the year ending April 5, 1918, and also an excess profits duty for the accounting period ended December 31, 1916 (R. 28). These taxes were paid pursuant to notices, one dated January 24, 1918, and the other dated January 19, 1918, which notices were the first notice, assessment, demand or information received by petitioner as to the amount of the taxes so payable (R. 28). Under the method of accounting regularly employed by petitioner in keeping its books throughout the year 1918, the accounting for expenses of its London Office was on a cash disbursements basis and no accruals were made for any such expenses in advance of their payment (R. 29). The British taxes paid in 1918 were expenses of petitioner's London Office and were entered on the petitioner's books of account at the time of payment in 1918 in accordance with the method of accounting regularly employed in keeping petitioner's books (R. 29). Except for expenses of the London Office and some additional small items where the cash basis was reflected, petitioner's books were kept on the

accrual basis and the principal and dominant purpose and plan of its accounts were to show income upon an accrual basis as the general and controlling character of the accounts (R. 29-30).

Petitioner took the credit in 1918. The Commissioner of Internal Revenue disallowed the credit thus taken, thereby increasing the tax payable for that year. The tax was paid by petitioner and suit was filed by it in the Court of Claims for recovery. The Court of Claims held that credit was not properly taken in 1918 and dismissed the petition.

It is not disputed that these taxes and duties were of the character allowable as a credit under Section 238 (a) of the Revenue Act of 1918. The question is whether credit may be taken (and the statutory provisions are the same as to the deduction of expenses) in the year of payment, when the method of accounting regularly employed calls for entry in the books of account on a cash disbursements basis, the majority of the taxpayer's accounts being upon an accrual basis but a considerable section of such accounts, as in this case all the London Office expense accounts of this petitioner, being on a cash basis.

IV.

SPECIFICATION OF ERRORS.

1. The Court of Claims erred in holding that the statutory phrase "method of accounting regularly employed in keeping the books of such taxpayer," describes only two systems of accounts, one a "strict cash basis" and the other a "strict accrual basis."

2. The Court of Claims erred in holding, in effect, that books must be kept and income returned upon either a strict cash basis or a strict accrual basis.

3. The Court of Claims erred in holding that petitioner was not entitled to a credit in 1918 for British taxes under Section 238 (a) of the Revenue Act of 1918, although it found as facts that such taxes were paid in 1918, and were entered on petitioner's books of account at the time of payment in 1918 in accordance with the method of accounting regularly employed in keeping such books.

4. The Court of Claims erred in considering as material the fact that accounts other than the London Office accounts to which the British taxes belonged, were kept on the "accrual basis," and in holding that under a method of accounting upon a mixed accrual and cash disbursements basis a credit was allowable according to the basis of the majority of the accounts regardless of the basis of the particular account in which the expenditure belonged.

5. The Court of Claims erred in denying to petitioner its claim for credit for British taxes paid in 1918.

6. The Court of Claims erred in dismissing the petition and in entering judgment for the defendant.

V.

ARGUMENT.

Summary of the Argument.

The case turns upon the meaning of the phrase "method of accounting regularly employed in keeping the books of such taxpayer," as it appears in Section 212 (b) of the Revenue Act of 1918. The question is important because the phrase appears in all the Revenue Acts since 1918 and governs the deduction of all expenses and the application of all credits. It has not

been decided by this Court and much confusion exists in the lower court and Board of Tax Appeals decisions in regard to it. Many taxpayers, especially corporations, are concerned in the answer.

The Court of Claims held that the phrase includes only two systems of bookkeeping, one a strict cash basis and the other a strict accrual basis, and that all deductions and credits must be made according to the predominant purpose of the accounts. This, we insist, was erroneous because it contradicts the language of the statute, runs counter to Departmental construction and to several decisions of this Court. No objection has, or can now, be made that the method of accounting used by this taxpayer failed to reflect accurately its income.

Where, as in this case, the accounts are, generally speaking, on an accrual basis but certain sets of accounts, due to some compelling peculiar condition, such as the operation of this petitioner's London office, are upon a cash basis, items entered on the books on a cash basis in accordance with that method should be deducted or credited on income tax returns in the year when they are paid.

The Statute.

Section 238 (a) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1080) provides:

> Section 238 (a). "That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by Title III shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States."

The petitioner's case depends upon the construction of the statutory provisions defining the term "paid," which provisions in the Revenue Act of 1918 are as follows:

> Sec. 200. "The term 'paid' for the purposes of the deductions and credits under this title, means 'paid or accrued,' or 'paid or incurred,' and the terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212."
>
> Sec. 212 (b). "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income * * *."

The Question of Statutory Construction Here Presented is an Important One Not Decided by This Court.

Importance of question.

The sections above quoted not only govern the application of the term "paid," "incurred" and "accrued" to foreign tax credits, but also to all other expenditures which may be allowable as deductions from income or as credits of another character. Therefore, the construction of these sections of the statute is of importance in connection with deductions and credits of every character and is not limited to the subject of foreign tax credits.

The phrase "method of accounting regularly employed in keeping the books of such taxpayer" (Sec. 212 (b) of Revenue Act of 1918) "according to" which the terms "paid or incurred" and "paid or accrued" shall be construed (Sec. 200 of the Revenue Act of 1918), is contained in all the Revenue Acts subsequent to the 1918 Act, including the statute now in force. Sections 200 and 212 of the Revenue Act of 1921, c. 136, 42 Stat. 227; Sections 200 and 212 of the Revenue Act of 1924, c. 234, 43 Stat. 253; Sections 200 and 212 of the Revenue Act of 1926, c. 27, 44 Stat. 9; and Sections 41 and 43 of the Revenue Act of 1928, c. 852, 45 Stat. 795. The question is therefore of continuing importance in respect of taxes for all years since 1918, and for future years so long as the statute retains its present provisions.

THE QUESTION NOT DECIDED BY THIS COURT.

When the method of accounting is on an accrual basis and the book entries in question are made as accruals or should be so made under the method of accounting regularly employed, it has been decided that the statute requires the deduction or credit to be taken in the year of accrual. *United States v. Anderson* and *United States vs. Yale & Towne Company*, 269 U. S. 422, reversing *Anderson v. United States*, 60 Ct. Cls. 106, and *Yale & Towne v. United States*, 60 Ct. Cls. 440; *American National Company vs. United States*, 274 U. S. 99.

When the method of accounting is on a cash receipts and disbursements basis, and the book entries in question are made as cash transactions or should be so made under the method of accounting regularly employed, it has been decided that the statute requires

the deduction or credit to be taken in the year of payment. *United States v. Mitchell*, 271 U. S. 9, reversing *Mitchell vs. United States*, 60 Ct. Cls. 451.

When the method of accounting is on a mixed accrual and cash disbursements basis, containing groups of accounts on the cash basis but a majority of the accounts on an accrual basis, and when the book entries in question are and should be on the cash basis under the method of accounting regularly employed, it has not been decided whether the deductions and credits should be taken in the year of payment in accordance with the basis of the particular accounts to which the expenditure belongs under the method of accounting regularly employed, or in the year of accrual in accordance with the basis of the majority of the accounts but contrary to the basis prescribed by the method of accounting regularly employed.

We emphasize that in this case the British tax payments were not isolated items in a set of accounts on the accrual basis but were a part of the London office expense accounts, all of which were on a cash disbursements basis under the method of accounting regularly employed by the petitioner (R. 29, findings IX and X).

CONFUSION AND UNCERTAINTY IN ABSENCE OF AUTHORITATIVE DECISION BY THIS COURT.

Much confusion and uncertainty exist in the application of these statutory provisions to mixed accounting systems. This Court's decision in *United States v. Anderson*, 269 U. S. 422; and *American National Company v. United States*, 274 U. S. 99, applied to the Revenue Act of 1916, and only the decision in *United States v. Mitchell*, 271 U. S. 9, applied to the Revenue Act of 1918. In all these cases, however, the Court

emphasized that the terms of the statute meant the method of accounting which was employed by the taxpayer and we think made it clear that such methods of accounting and not some abstract rule of accrual or cash basis was to govern the year in which deductions or credits might be taken. Notwithstanding these decisions of this Court, there has been a persistent tendency on the part of the Commissioner of Internal Revenue and the lower courts arbitrarily to divide all accounting systems into two methods, one a cash receipts and disbursements basis and the other an accrual basis.

The Court of Claims in its decision herein cited this Court's decision in the *Anderson* case as authority for the proposition that when only a part of the accounts are on a cash basis, all deductions and credits must be taken on the accrual basis regardless of the method of accounting employed. We think the Court did not intend to sanction any such arbitrary departure from the method of accounting regularly employed by the taxpayer.

The decisions of the federal district courts and the circuit courts of appeals involving these statutory provisions (*Stieff v. Tait*, 26 Fed. (2d) 489; *Hyams Coal Co. v. United States*, 26 Fed. (2d) 805; *Bacon Grain Co. v. Reinecke*, 26 Fed. (2d) 705; *American Code Company v. Commissioner*, 30 Fed. (2d) 222; *Consolidated Tea Co. v. Bowers*, 19 Fed. (2d) 382), do not lay down any rule for application to a mixed system of accounting.

The *Hyams Coal Company* and the *Bacon Grain Company* cases perhaps intimate that a strict accrual or strict cash basis must be applied rather than the basis of the accounting system actually employed. If

such is the view expressed, it is, we submit, contrary to the mandate of the statute and in conflict with the views expressed by this Court.

The decisions of the Board of Tax Appeals are in considerable confusion on this question. It has stated that a taxpayer must follow "one of the two alternative bases provided by stat te for keeping accounts." *Henry Reubel, Executor,* 1 B. T. A. 676. See also *Coatesville Boiler Works,* 9 B. T. A. 1242. This rule was explained by the Board in a later ruling as follows:

> "The reason for such holding was that such a method resulted in a distortion of income as not having a regular and consistent method but leaving it uncertain as to how various items might be treated, and making it difficult, if not impossible, to verify the correctness of the result. * * * The basis of the conclusion reached by us in the cases cited above was the necessity to require methods of accounting which would clearly reflect income. To so construe those decisions as to lay down a hard and fast rule requiring every business owned by the same individual or the same partnership to use the same method of accounting irrespective of whether it correctly reflects income would be to defeat the object sought." (*Joseph Stern, et al.,* 14 B. T. A. 838, 843.)

As we shall later point out in this brief no contention has been made by the Government that this petitioner's method of accounting did not clearly reflect the income, and thus the petitioner's method does not violate the rule of the Board.

In other cases the Board has said:

> "Clearly the statute does not say what the method of accounting should be. It does not single

out one of two methods to the exclusion of all others." (*Morris-Poston Coal Company*, 13 B. T. A. 344, 349.)

And in *Great Northern Railway Company*, 8 B. T. A. 225, 268, the Board in approving a mixed accounting method kept in accordance with rules prescribed by the Interstate Commerce Commission said:

> "The statute does not lay down two alternative bases for keeping accounts and making returns of income." (*Great Northern Railway Company*, 8 B. T. A. 225, 268.)

To remove the prevailing confusion and uncertainty, a decision of this Court is needed on the meaning of the statutory provisions here in question when applied to an accounting system on a mixed accrual and cash basis.

Many taxpayers interested.

Practically all systems of accounting for any substantial amount of business are on a mixed basis (R. 38). (Opinion, p. 9.)

Practical considerations of a compelling nature frequently require a mixed system of accounts. Kohler on Federal Income Taxes (1927 p. 46) says, "Perhaps no set of books exists in which all accounts are handled on a strict accrual basis." The manufacturing and general financial accounts of any large business must be kept on an accrual system in order to permit effective management and control. But if the refinements of an accrual system are extended to every department

and section of an extensive business, the accounting system becomes unwieldy and burdensome, particularly when parts of the accounts must be kept at points distant from the principal accounting office. Therefore, certain groups of accounts are often kept on a cash basis.

So in this case the accounts of petitioner's office in a distant foreign country were kept on a cash basis. That group of accounts always has been kept on such basis and doubtless always will be. Many other companies have similar situations requiring the use of mixed accounting systems.

The rule governing allowable deductions and credits under such accounting systems is therefore of interest and often of importance to large numbers of individuals and corporations whose accounts are so kept. Its determination is of importance not only in deciding controversies regarding taxes but also that taxpayers may know whether the Revenue Laws permit the keeping of books on a basis other than the strict accrual basis or the strict cash basis.

The Statute Has Been Misconstrued by the Court of Claims.

The pertinent statutory provisions previously quoted in full, *supra*, may be summarized as follows:

> "The term 'paid' * * * means 'paid or accrued' or 'paid or incurred' * * * (which terms) shall be construed according to the method of accounting upon the basis of which the net income is computed * * *. The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers."

Further abbreviating, the statute requires that the terms "paid or accrued" and "paid or incurred" shall be construed according to the method of accounting regularly employed in keeping the taxpayer's books.

The Court of Claims construed these statutory provisions as follows:

> "The right to recover depends in this instance upon whether the plaintiff kept its books on an accrual or cash basis. An examination of its books and its system of accounts by the Commissioner of Internal Revenue satisfied that official that they were kept on an accrual basis *within the meaning of the statute*, and he so ruled.
>
> "The Court has found that while it appears that some of the accounts of the plaintiff were kept upon a cash basis *and the British account among them*, it does not clearly appear what proportion was kept on the accrual basis, or that the greater proportion of its business was not kept upon the accrual basis * * *.
>
> "Where only a relatively small part has been on the cash basis it must be held that the income should have been returned upon an accrual basis." (Italics ours.) (R. 38-39.)

We submit the Court of Claims erred in this construction.

The phraseology of the statute.

It seems to us that the terms of the statute are both simple and plain. The words are "the method of accounting regularly employed in keeping the books of such taxpayer." Nothing mysterious or difficult appears there. In fact, more simple English language would be difficult to select. One single qualification appears to that clause, and that is that the method

employed must clearly reflect the income, which qualification we shall later discuss.

The statute does not require that income shall be returned upon the cash basis or upon the accrual basis or upon the basis upon which the majority of the accounts may be kept. The statute uses neither the term "cash" nor the term "accrual." It requires only that the return of income shall be "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." The language of the statute plainly negatives the construction placed thereon by the Court of Claims. It seems obvious that the lower Court has overlooked and failed to give effect to the phraseology of the statute, in holding that the books were "kept on an accrual basis *within the meaning of the statute*" (R. 38) and that the statute required the income to be returned upon an accrual basis "where only a relatively small part" of the accounts are kept on the cash basis.

CONTEMPORANEOUS DEPARTMENTAL CONSTRUCTION.

The regulations promulgated by the Treasury Department under the Revenue Act of 1918 recognized that the statute did not attempt to prescribe alternative methods of accounting or any particular method of accounting to the exclusion of other methods. Regulations No. 45, promulgated under the 1918 Act, contained as part of Article 24 the following opening sentence, under the heading "Methods of Accounting":

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose."

Exactly the same sentence is contained in the regulations issued under the Revenue Acts of 1921, 1924, 1926, and 1928. (Art. 24 of Regs. 62, 65 and 69 and Art. 323 of Regs. 74.)

This contemporaneous departmental construction, announced soon after the enactment of the Revenue Act of 1918 and consistently adhered to in the construction of similar provisions of subsequent Revenue Acts including the one now in force, clearly refutes the interpretation placed upon the statute by the Court of Claims in its decision in this case.

The decisions of this Court.

In the cases in which phases of this question have come before this Court, the accounting method actually employed by the taxpayer has been held to be controlling. To this effect were the decisions in *United States vs. Anderson*, and *United States vs. Yale & Towne Co.*, 269 U. S. 422, *American National Company vs. United States*, 274 U. S. 99, *United States vs. Mitchell*, 271 U. S. 9, *Fourth and Central Trust Company, Executor, vs. United States*, 278 U. S. 604, denying certiorari in case reported at 65 Ct. Cls. 96.

In the opinion in the Anderson and Yale & Towne cases, *supra*, the Court said:

> "It should be noted that Sec. 13(d) makes no use of the word 'accrue' or 'accrual' *but merely provides for a return upon the basis upon which the taxpayer's accounts are kept*, if it reflects income—which is precisely the return insisted upon by the Government. We do not think that the Treasury decision contemplated a return on any other basis when it used the terms 'accrued' and 'accrual' and provided for the deduction by the

taxpayer of items 'accrued on their books.'" (269 U. S. 422, 441)

In U. S. vs. Mitchell, *supra*, the Court said, p. 12:

> "The return shows that it was made on the basis of income actually received in 1919. This indicates that the accounts were kept on the basis of actual receipts and disbursements, and there is nothing in the record to show that any other method was employed. The burden is on the executors to establish the invalidity of the tax. *United States v. Anderson, supra.* They have not shown that their books were kept on the accrual basis. Assuming, as we must, that the accounts of the estate were kept on the basis of actual receipts and disbursements, the executors were required to make return on that basis."

Thus in all of the decided cases the accounting method actually employed by the taxpayer has been held controlling in determining whether deductions or credits shall be taken when paid or when accrued. None of these cases are authority for the proposition announced by the Court of Claims in this case that the basis of the majority of the accounts must govern and the basis actually employed in accordance with the regular accounting method must be ignored. Such a proposition is distinctly negatived by the opinions of this Court in the cases above cited and by the uniform adherence of this Court to the method of accounting actually employed in deciding these questions.

The Lower Court's Decision Cannot Be Supported on Ground that Petitioner's Method of Accounting did not Clearly Reflect Income.

As has been shown, the rule clearly contained in the statute is that the method of accounting regularly em-

ployed governs. That method of accounting cannot be ignored or modified except upon one condition, namely, that such method of accounting does not clearly reflect the income, in which event the Commissioner is authorized to make the computation in such manner and upon such basis as in his opinion does clearly reflect the income.

That condition has no application in this case. The Court of Claims did not rest its decision upon that provision of the statute and at no time in the progress of this case, either before the Bureau of Internal Revenue or before the Court of Claims, was there ever any contention that petitioner's method of accounting did not clearly reflect income.

Furthermore, this is a question of credit of foreign income taxes against domestic taxes and not a deduction of an expense from gross income and, therefore, the question of clearly reflecting income cannot and does not arise in this case.

Should the question be considered pertinent, if raised in this Court for the first time, the record clearly shows that petitioner's method of accounting, as a method, was accepted by the Commissioner of Internal Revenue for all other years (R. 29). The findings of fact show that for the year 1919, the British income tax for the year subsequent to the British income tax involved in this case, was paid in 1919 and claimed as a credit in that year and so allowed by the Government (R. 29). It is also shown that the British income tax for the next year, ending April 5, 1920, was not paid until 1924 and that the Commissioner made no adjustment transferring this payment to the account of earlier years which would have been necessitated had the petitioner's method of accounting been re-

jected. Moreover, this item was but one of the London office expenses, all of which were treated upon the cash basis. None of the other numerous adjustments which would have been necessary in petitioner's London office accounts, had petitioner's method of accounting been rejected as not clearly reflecting income, were made or even proposed by the Commissioner of Internal Revenue or by any other Government officer.

Moreover, there was at one time a Departmental Regulation specifically approving the precise act of this petitioner now complained of. In Regulations 33, Article 158, issued January 5, 1914, under the Revenue Act of 1913, the Treasury Department held that deductions might be taken when "so entered on the books of the corporation as to constitute a liability against the assets of the corporation," with the sole and specific exceptions of taxes and losses, which, it was provided, must be deducted when paid. "Deductions for taxes, however," said the Regulations, "should be the aggregate of the amounts *actually paid,* as shown on the cash book of the corporation." Here was a mixed basis of deduction clearly recommended, and even required, as a variation of the accrual method, by the Treasury Department over the signature of the Secretary of the Treasury.

It is not our position that an entry in the books of account is controlling if that entry is contrary to the accounting system and not the kind of entry that the method of accounting regularly employed requires. But if the entry is in accordance with the method of accounting regularly employed, and in this case the findings of fact so show (R. 3), the statute requires that the actual entry must be given effect and the deduction or credit of that item must be determined in accordance with the entry.

The situation here presented is not that of an isolated entry on a cash basis in an accounting system on a strict accrual basis. Here a separate and distinct group of accounts, those pertaining to the London office of petitioner, were regularly on a cash basis. The principal accounts in the United States were on an accrual basis; some of the minor domestic accounts were also on a cash basis. Thus petitioner had a definite and well formulated method of accounting devised to meet the requirements of its business. The basis for each class of accounts was uniformly and consistently applied. It has never heretofore been suggested and it cannot be successfully contended that this method of accounting failed clearly to reflect petitioner's income.

Conclusion.

The correct construction of the statute is that the terms "paid or incurred" and "paid or accrued," wherever used in the Act, mean *paid* for all items which under the taxpayer's method of accounting are regularly entered on the cash disbursements basis; that they mean *incurred* or *accrued* for all items which under the taxpayer's method of accounting are regularly entered on the accrual basis; so long as no objection is made that the accounts thus kept do not reflect accurately the income. Applying the rule to this case, the term "paid" in section 238(a) of the Revenue Act of 1918 means "paid" and not "accrued" in relation to the British taxes here in question, for those British tax payments were entered on petitioner's books on the cash disbursements basis in accordance with the method of accounting regularly employed. The foreign tax payments, paid in 1918, are therefore allowable as a credit for that year.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, in order that the construction of an important provision of the Revenue Acts may be definitely settled and that an error in the construction and application of such statutory provision may be corrected; and to such end that a writ of certiorari should be granted and this Court should review the decision of the Court of Claims and finally reverse it.

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